Market Pulse Report

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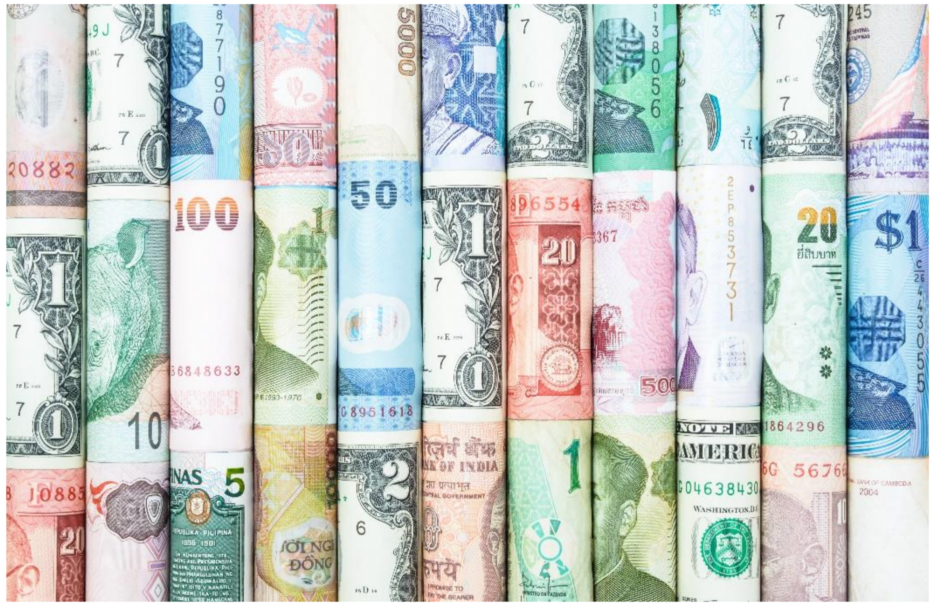

SUMMARY

Thanks in part to the prospects of an accelerated pace of Federal Reserve rate hikes, many expect continued strength in the U.S. dollar as we head into 2017. If that turns out to be the case, the tangled web of currencies and corporate earnings could make it tough for U.S. markets to maintain their recent dominance.

While a rising dollar hurts the near-term performance of non-U.S. investments (when translated back into dollar terms), over longer timeframes weaker foreign currencies can improve the competitiveness of businesses outside of the U.S.

Emerging markets in particular may benefit from stronger potential growth and attractive valuations, making them a compelling long-term investment opportunity.

An Entangled Web of Monetary Policy, the Dollar, and Overseas Stocks

2016 was certainly eventful for stock investors. Market participants endured a sharp sell-off early on thanks to the oil price collapse, Chinese growth fears, unexpected political events (Brexit and the U.S. election), inexplicably low/negative bond yields in many parts of the world, and perhaps the most-anticipated Federal Reserve rate hike in history. Despite all of this, U.S. stocks settled the year with substantial gains and near record highs (the Dow Jones Industrial Average is even flirting with the 20,000 milestone).

Overseas equity markets, however, were not quite as fortunate. While the S&P 500 posted a solid gain of 12.0% in 2016, international stocks (as measured by the MSCI All Country World Index ex U.S., which includes both developed international as well as emerging markets) was up a more meager 5.0% in dollar terms. This continued the multi-year trend of overseas underperformance—over the past three years, the overseas benchmark has lost ground (-1.3%) compared to the U.S. market index—up nearly double digits (+8.9% annualized). Many investors with allocations to international stocks might be shaking their heads with frustration, especially in light of the post-election surge which has heavily favored domestic exposures.

But despite 2016's backlash against globalization, the world's investment landscape is more intertwined than ever. The key question on the minds of many investors is whether 2017 will bring more of the same or if overseas markets are poised to—at long last—live up to expectations.

Monetary Policy Divergences. Let's take a look at monetary policy as a starting point. It's no secret that central bank activities and policies affect not only interest rates and, theoretically, economic growth, but also currency exchange rates. A region with rising rates tends to see a boost to domestic currencies as money flows into the local economy seeking that extra yield. Rate cuts and bond buying, on the other hand, tend to depress a currency by flattening yields and sending investors looking for income elsewhere. Why is this important? Because currencies, in turn, can have an influence on economic activity (as we will discuss below).

So where do global monetary policies now stand? As widely expected, the U.S. Federal Reserve last month once again raised short-term interest rates. Not only that, but forecasts showed the Fed sees rates rising faster next year than previously thought (three hikes in 2017 versus the prior projection of just two). Contrast that with Japan and Europe, where key rates remain in negative territory and their respective central banks continue to enact massive bond-buying programs. The disparity between a tightening U.S. Fed and the easing major overseas central banks has helped fuel a dollar rally and may put further upward pressure on the dollar in 2017. But hold that thought, because a resurgent dollar may ultimately be one of the more significant risks for U.S. markets.

Dollar Strength is a Mixed Bag. Even prior to the recent Fed rate hike, the dollar has been on a rallying trajectory as investors anticipate the President-elect's promises of a more expansive fiscal policy to boost U.S. economic growth and inflation. The greenback recently reached a 14-year high, with the U.S. Dollar Index surging 7% over the past three months.

A rising dollar can have good and bad implications. In the near term, dollar strength may help drive asset flows into the U.S. and benefit domestic *consumers* (who pay lower prices for imports). Domestic *investors* with diversified portfolios, on the other hand, are well aware that a stronger dollar has an immediate and negative impact on overseas stock returns when converted into U.S. dollar terms. These aspects have many investors questioning the wisdom of diversifying into international investments if further dollar strength is anticipated.

But not so fast! The full ramifications of a rising dollar take more time to be felt, and they are not all beneficial to U.S. companies and investments. As was the case in 2014-2015, many U.S. companies that sell into global markets could once again see earnings hindered as their exports suddenly become more expensive overseas. Furthermore, foreign earnings end up worth less to these U.S.-based companies when translated back into dollars. Companies domiciled in Europe and Japan, on the other hand, are presented an opportunity thanks to pricing power benefits. Over time, the competitive advantages that international companies receive from their weaker currencies versus the dollar should start to be reflected in corporate earnings and comparative stock market returns.

That all said, currency movements are notoriously fickle, difficult to predict and other fundamental factors can often have a greater impact on equity returns. While the dollar's near-term path of least resistance appears to be higher, the magnitude of additional gains is an open question. The dollar may be getting considerable attention, but the decision to allocate to overseas markets should not be based on currency factors alone.

International Stock Exposure. Broadly speaking, there are several reasons to allocate to international equities beyond advantages they may (or may not) see from a currency standpoint. First and foremost, exposure to global regions is essential to fully participate in global growth. The U.S. economy, while still the largest in the world, accounts for only about a quarter of global GDP. Focusing solely on the U.S. ignores a large set of potentially attractive companies. We strive to find managers who invest in companies with the best growth potential, regardless of where they are located. Moreover, different geographic regions provide a diverse source of return drivers supported by various economic fundamentals and factors of production (land, labor, and capital).

Furthermore, future stock returns are a function of valuations as well as corporate earnings. As we exit 2016, the U.S. is left on the expensive side (as measured by cyclically-adjusted price/earnings ratios) while Europe and emerging markets are cheaper. If investors are pricing U.S. markets for perfection, the disparity in returns going forward could narrow regardless of economic outcomes. And with Fed uncertainty, Trump policy unknowns, and the specter of rising interest rates and a stronger dollar, U.S. economic outperformance is no sure thing.

Now, it's not all roses for international markets. Europe is still facing structural and slow growth issues—central bank stimulus and currency devaluation can help offset but not fully resolve these issues. And while a stronger dollar can be beneficial to the earnings of many overseas companies, it can also add pressure on emerging-market nations by making their dollar-denominated debt more expensive to pay back.

Currently, developed international regions are a mixed bag. Europe and Japan continue to look for ways to overcome demographic and regulatory challenges. European markets are still perplexed by what Brexit will ultimately mean, with more political uncertainty on tap for 2017 in the form of French and German elections. On the other hand, overseas central banks remain extremely accommodative and significant devaluation in the Euro, British Pound and the Yen should put exporting companies in those countries in a better position to compete relative to the U.S.

Emerging markets, meanwhile, offer better value (thanks to depressed pricing over the past several years) compared to the developed world. With an expanding and urbanizing middle class, economic growth in emerging regions is expected to outpace that of developed regions, giving these regions a larger role in the global economic and market landscape. But there is something to be said for selectivity, as there can be a wide disparity across emerging market stocks, as it is not a homogenous asset class. Active managers may be able to avoid exposure to problem areas (such as those countries more sensitive to Fed tightening, dependent upon foreign investment, or with heavy external debt levels) while focusing on countries with the best growth and income opportunities. The longer-term outlook for emerging markets is relatively attractive as compared to developed regions, but one must stomach the short-term volatility (and periods of underperformance) in order to reap the long-term rewards.

Conclusion. Currencies play a role, but over time their impact is often not so crystal clear. That said, the prospect of a stronger dollar (alongside rising interest rates and relatively more expensive valuations) may contribute to a more subdued *intermediate-term* return outlook for the U.S. equity markets as compared to other regions.